

# VERTICAL SYSTEMS ANALYSIS

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## FOREWORD

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Vertical relationships have long been recognized as having a significant influence on the behavior and performance of industrial organizations. Yet, the preponderance of empirical and theoretical work has focused on horizontal competitive relationships. At least in part, this may be due to the difficulty of developing adequate conceptual models of vertical market relationships. Although there have been several recent efforts to improve the conceptual models of vertical market systems, vertical systems analysis must still be considered in the embryonic stage of development. Scholarly contributions have provided some useful insights into the characteristics of vertical systems, and have contributed to a broader Weltanschauung of economic activity. However, one could hardly consider that they constitute a valid theory of vertical system behavior.

Perhaps the key problem in the conceptualization of vertical market systems is the interaction of firms at different levels within a system. The paucity of research on interorganizational behavior results in few theoretical insights into vertical market relationships. Because exchange in a vertical system often depends in part on negotiation skills, market power, and factors in addition to traditional demand and cost functions, the models of economics only suggest a range of possible outcomes.

Quite understandably, some of the recent inquiries into vertical system behavior have attempted to apply concepts from the behavioral sciences.

Stern views market channels as social systems involved in performing economic functions. He contends:

"Channels can be viewed strictly as economic systems; however, such a perspective also limits knowledge of the relationships and interactions within them. The perspective must be broadened to include social and behavioral variables, for channels are social systems first and then economic systems."<sup>1</sup>

Past studies of vertical market systems can be categorized into at least three different orientations.

1. Descriptions and analyses of the physical flow of products, the value added and functions performed at different stages, and the structure of the industries operating at different stages. This approach provides a snapshot of a system at a point in time, but often gives little insight into the dynamic properties of a vertical system.

2. Description and analysis of vertical system coordination, including the institutions and arrangements involved in communication and exchange within the system. This approach examines one of the essential dynamic functions of vertical systems, but generally assumes the existing or a hypothetical organization and purpose of the system.

3. Description and analysis of vertical system adaptation and evolution, including the forces of change or inertia. This approach is longer range in perspective, focusing on a second critical dimension of systems -- that of adaption and adjustment.

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<sup>1</sup>Stern, Louis W., Distribution Channels: Behavioral Dimensions, Houghton-Mifflin Co., Boston, Mass., 1969, p. 5.

The first approach is a rather straight forward anatomical examination of a system, and at least to some extent is required before the coordination or adaptation aspects of the system can be examined. The performance of vertical systems, however, are heavily dependent upon the efficacy with which coordination and adaptation are accomplished. Since both of these tasks carry significant behavioral dimensions, let us consider some of the behavioral concepts that are applicable to vertical system analysis.

### Behavioral Dimensions

Vertical market systems inherently involve both cooperation and conflict. For a vertical complex of organizations to be considered a "system", some degree of interdependency is required. Vertical interdependency, in turn, means some commitment to the survival of the system and other system members. The level of commitment of system members determines the extent to which their individual interests will be subordinated to the effectiveness of the total system -- and hence to the level of cooperation that will prevail.<sup>1</sup>

Wroe Alderson has emphasized the cooperative aspects of market systems, contending that a theory of cooperation is needed to accompany

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<sup>1</sup>See Wroe Alderson's comments about organized behavior systems in Dynamic Marketing Behavior, Richard Irwin, Homewood, Ill., 1965, p. 37 - 45. Alderson perceives an organized behavior system as a group perpetuated by the members' belief that they have more to gain by belonging to the group than by independent action. Alderson draws a definite distinction between an organized behavior system (where each member has a stake in the survival of others) and a loose coalition of firms.

theories of competition.<sup>1</sup> Baligh and Richartz have commented:

"The essence, therefore, of any vertical market structure is the cooperation that must of necessity exist for exchange to occur."<sup>2</sup>

Cooperation within vertical systems would appear to be particularly important in contributing to smooth coordination, and to system equilibrium.

Baligh and Richartz suggest three requisites for system equilibrium.

"The first is that every firm within the structure be incapable of changing the cooperative relationships which it has with other firms already in the structure to its economic advantage... Second...no firm from without the structure finds it possible and profitable to alter it by entering into cooperative relationship with those firms already a part of the structure...Third... that every firm in the structure at equilibrium performs a function."<sup>3</sup>

While cooperation is an essential ingredient for system survival, conflict may be an equally natural -- and perhaps equally important -- dimension of vertical systems. In an interdependent system, the behavior of one member frequently threatens the goal satisfaction of other members. Conflict results.

Dahrendorf has contended that, in fact, conflict and change are ubiquitous in social systems; that equilibrium models, therefore, provide a distorted and incomplete understanding of system behavior. He comments:

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<sup>1</sup>Ibid, p. 239.

<sup>2</sup>Baligh, Helmy H. and Richartz, Leon E., Vertical Market Structures, Allyn & Bacon, Inc., Boston, Mass., 1969, p. 3.

<sup>3</sup>Ibid, p. 8.

"All utopias from Plato's Republic to George Orwell's Brave New World of 1984 have had one element of construction in common: they are all societies from which change is absent.

...whether by rational argument or empirical analysis, it is hard to link the wide river of history -- flowing more rapidly at some points, or slowly at others, but always moving -- and the tranquil village pond of utopia.

...at least one other model of society is required. The model I have in mind has as long a tradition as the equilibrium (social systems) model...this alternative model (is) the "conflict model of society"...all units of social organization are continuously changing, unless some force intervenes to arrest this change. It is our task to identify the factors interfering with the normal process of change rather than to look for variables involved in bringing about change.

...As with change, we have grown accustomed to looking for special causes or circumstances whenever we encounter conflict; but again a complete about-face is necessary in our thinking. Not the presence but the absence of conflict is surprising and abnormal, and we have good reason to be suspicious if we find a society or social organization that displays no evidence of conflict. To be sure, we do not have to assume that conflict is always violent and uncontrolled. There is probably a continuum from civil war to parliamentary debate, from strikes and lockouts to collective bargaining...we must never lose sight of the underlying assumption that conflict can be temporarily suppressed, regulated, channeled and controlled, but that neither a philosopher-king nor a modern dictator can abolish it once and for all.

There is a third notion that goes with change and conflict to make up the armamentarium of the conflict model of society; the notion of constraint. From the point of view of this model, societies and social organizations are held together not by consensus but by constraint, not by universal agreement but by coercion of some by others. It may be useful for some purposes to speak of the "value system" of a society, but in the conflict model such characteristic values are ruling rather than common, enforced rather than accepted, at any given point in time. And, as conflict generates change, so constraint may be thought of as generating conflict.

...Because there is no certainty...there has to be constraint to assure some livable minimum of coherence. Because we do not know all the answers, there has to be continuous conflict over values and policies. Because of uncertainty, there is always change and development...the conflict model is essentially non-utopian; is the model of an open society... we need both [the equilibrium and the conflict] models for the explanation of sociological problems. Indeed, it may well be that society, in a philosophical sense, has two faces of equal reality; one of stability, harmony, and consensus, and one of change, conflict, and constraint."<sup>1</sup>

While Dahrendorf's comments are aimed at social systems in general, they are germane in considering vertical market systems and business organizations. One finds, for example, that certain vertical systems and firms are characterized by rapid change, conflict and re-organization. In others -- often where technology is more dormant -- stability, harmony, and efficient organization are dominant features.<sup>2</sup>

The comments of Cyert and March strike some similar notes, albeit related to organizations. They view an organization as a coalition, but one that naturally embodies some degree of conflict.

"Basic to the idea of coalition is the expectation that the individual participants in the organization may have substantially different preference orderings (i.e., individual goals). That is to say, any theory of organizational goals must deal successfully with the obvious potential for internal goal conflict inherent in a coalition of diverse individuals and groups."<sup>3</sup>

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<sup>1</sup>Dahrendorf, Ralf, "Essays in the Theory of Society", Stanford University Press, Stanford, California, 1968, p. 107, 108, 126 - 128, bracketed phrases added.

<sup>2</sup>For an interesting analysis of the organization and behavior of firms in different types of environments, see Lawrence, P. and Lorsch, J., Developing Organizations: Diagnosis and Action, Addison-Wesley Co., Reading, Mass., 1969.

<sup>3</sup>Cyert, Richard and March, James, A Behavioral Theory of the Firm, Prentice-Hall, Inc., Englewood Cliffs, N. J., 1964, p.27.



It may well be that sufficient similarities exist between intra-organizational behavior, and the behavior of organizations within a vertical system, that studies of the former can provide many useful insights into the latter. Certainly, at this point in time, theories of organizational behavior are farther along in development than theories of vertical system behavior.

### Coordination and Adaptation

Cooperation and conflict are important characteristics of vertical systems, not in and of themselves, but because of their effect on system coordination and adaptation, and on competition at different levels in a system. Coordination is relied upon to integrate and synchronize the functional inputs of different system members in order to achieve a smoothly functioning whole that effectively achieves its purpose. Adaptation reflects the extent to which the system is responsive to its environment and adjusts accordingly. Over time, the relevancy and survival of the system are at stake. While volumes have been written about competition, the basic nature of coordination and adaptation have received much less attention. A few comments appear warranted.

Coordination -- At any given point in time, coordination of a vertical system depends upon:

- existing institutions and arrangements (including markets, rules and regulations, trade practices, and facilitating organizations)
- the flow of information (including its accuracy, quantity and timing)
- decisions

Existing institutions and arrangements are the instruments or the vehicles through which coordination takes place. They have a strong influence on the extent to which market signals are accurately and promptly relayed to system members -- and hence on system responsiveness. One of the benefits from contracts, as compared to spot markets in linking system members, is the increased information flow that often occurs. If the contract is part of a long term continuous relationship, higher levels of cooperation and understanding might also be expected, although this depends upon the degree of dependency of each party on the other.

Given the institutions and arrangements and flow of information in the system, management decisions actually perform the coordinating task. In this respect, the concept of a system "decision anatomy" may be analytically useful. The decision anatomy refers to the network of decision points and associated authority extending throughout the system. It represents the "nervous system" by which coordination and adjustments take place.<sup>1</sup>

The decision anatomy of a system provides an overall view of the control points and the distribution of authority and influence for the entire system. Few decisions are made at the system level, however.

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<sup>1</sup>For further comments on this approach, see Henry B. Arthur, et al, Tropical Agribusiness Systems: Bananas, Division of Research, Graduate School of Business Administration, Harvard University, 1969, Chapter 7; also Marion and Arthur, "Dynamic Factors in Vertical Commodity Complexes: A Case Study of the Broiler Industry", forthcoming research bulletin, Ohio Agricultural Research & Development Center, Wooster, Ohio.

Rather, decisions are made by individuals and groups of individuals as they perform certain roles within the firms and organizations that make up the system. Thus, the structure of authority and decisions within the organizations in the system also have a bearing of coordinating decisions. Lawrence and Lorsch found, for example, that firms facing rapidly changing and uncertain environments need to have a relatively flat organizational structure in which considerable authority and freedom is delegated to lower levels. On the other hand, firms in a relatively unchanging environment can operate with less delegation, tighter internal controls and simpler channels of communication.<sup>1</sup> Since an organization must carry on transactions with its environment simply to survive, the characteristics of the organization need to be consistent with the various segments of the environments with which it deals.

The foregoing suggests the importance of understanding the distribution of authority and decisions within a system. Attempting to understand why certain decisions are made requires examining yet another dimension -- the set of forces bearing on decision makers. These include: competitive forces, the goals and values of individuals and organizations, their perceived role and power in the system, economic-political-social forces, etc. Both the forces and the interpretation of them may change from one decision point to another. The greater the

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<sup>1</sup>Lawrence and Lorsch, Developing Organizations...., op. cit.

difference in the set of forces bearing on decision makers at different levels in the system, the more difficult the integration and coordination task.

### Adaptation

Vertical systems are generally evolving systems, as opposed to steady state systems. They are continually adjusting and adapting to pressures and imbalances emanating from horizontal competition, vertical conflict, and environmental forces. This is not to suggest, however, that all vertical systems are equally responsive and adaptive. Quite clearly, history suggests that this is not so.

The factors influencing a system's adaptability are open to conjecture. McCammon has suggested:

"...institutional change in marketing tends to be a process in which firms and channels maneuver for short-run advantage and in which they adapt almost imperceptibly to environmental disturbances."<sup>1</sup>

Since members of established vertical systems often resist or respond only incrementally to innovations, major innovations -- particularly those that threaten to restructure the system -- are generally introduced by firms completely outside the system. Relatively free entry would therefore appear to be important to system adaptability.

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<sup>1</sup>McCammon, Bert C. Jr., "Alternative Explanations of Institutional Change and Channel Evolution", in The Marketing Channel: A Conceptual Viewpoint, ed. by Bruce Mallen, John Wiley & Sons, New York, 1969.

The structure and control of the vertical system may also influence its responsiveness and adaptability. Although empirical data are lacking, one might hypothesize that the accuracy with which consumer preferences are transmitted (and hence the possibility that system adjustments will be relevant) improves when retail outlets are organized (so they have some power in the market place), are free of significant manufacturer control, and handle the products of several manufacturers, as compared to the opposite extreme of manufacturer owned and controlled retail outlets.

In addition, logic suggests other influences on system responsiveness, such as the presence of innovative firms at different levels in a system to set the pace for others, the growth-maturity stage of the system, the existence of government guarantees or other shields from market forces, and the balance of conflict and cooperation in the system.

### Performance of Vertical Systems

"Our perspective of (system) performance may be that of a critic evaluating the system in the light of its contributions to society or that of the individual entrepreneur seeking to survive and prosper within the system."<sup>1</sup>

In either case, however, one encounters the dilemma of whose goals are to be chosen, and how are they to be aggregated. Streamlined, efficient and tightly coordinated systems are desirable, as are innovative, adaptive and responsive systems. But, can both types of performance be realized in the same system? There is no clear answer. It seems likely

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<sup>1</sup>Bucklin, Louis P., ed., Vertical Marketing Systems, Scott, Foresman & Co., Glenview, Illinois, 1970, p.3.

that both sets of system characteristics are present to some degree in all systems. However, the balance varies greatly. In discussing market organization and economic development, Preston suggests:

"....the evaluation of marketing-organization alternatives in the development context requires consideration of the informational, adaptive, and innovational functions of marketing agencies as well as their routine distribution of staple product lines. The most efficient organizational patterns for distributing standard products to existing markets are probably the least desirable ones for rapid and imaginative market development."<sup>1</sup>

In studying the U. S. food industries, Handy and Padberg found that two parallel vertical systems are emerging.<sup>2</sup> One of these links core manufacturers and fringe retailers in a system that emphasizes product progressiveness and non-price competition. National brands and in-store merchandising and service are primary competitive weapons.

The second system links core distributors with fringe manufacturers in a system emphasizes physical efficiency and economy. Private labels and low prices are important competitive weapons.

While such parallel system are not developed for all products, for the large majority of products handled in supermarkets, they are. From a performance standpoint, this arrangement results in consumers having greater choice in the market place, and benefit ing from both product

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<sup>1</sup>Preston, Lee, "Market Organization and Economic Development: Structure, Products and Management", in Vertical Marketing Systems, op. cit., p. 133.

<sup>2</sup>Handy, C.R. and Padberg, D.E., "A Model of Competitive Behavior in Food Industries", American Journal of Agricultural Economics, May 1971.

progressiveness and product economy. While core distributors and core manufacturers continue to deal with one another, their interdependency has likely declined. Direct confrontations between the two locuses of power are largely avoided.

One of the important factors leading to the development of parallel systems has been the development of a distribution oligopoly in food. Without question, the large core distributors are the captains of the private label vertical systems. In industries where distribution oligopolies have not developed, private label economy-oriented vertical systems have generally not developed to the same extent as in the food industries.

In this case, it appears that one vertical system could not perform equally well, considering both product progressiveness and economy dimensions of performance; and that different performance criteria are warranted in evaluating the two parallel systems.

While at this point, the opportunities for the development of similar parallel systems in other industries is not clear, the food industry model does suggest that expecting a given vertical system to be both progressive in developing new products and highly efficient may be unrealistic. Perhaps the more realistic approach is to evaluate systems in terms of their primary performance characteristic, and encourage the development of alternative systems that specialize in providing other desired aspects of performance.

In recent years, planned vertical systems have become more numerous. Large retailers such as Sears and Kroger now control significant portions of their supply networks through ownership, joint-ventures or contracts. Kentucky Fried Chicken, the nation's largest fried chicken company, now operates its own vertically integrated broiler growing and processing system. Some of the motel chains, such as Holiday Inn, have integrated vertically into industries supplying them.

In many cases, planned vertical systems have also stemmed from the initiative of manufacturers. For example, tire, paint, clothing and dairy manufacturing companies have developed chains of retail outlets to distribute their products.

McCammon suggests that there are three basic types of planned vertical systems.<sup>1</sup>

1. Corporate -- based upon vertical ownership
2. Administered -- coordination is achieved by programs developed by one or more firms; depends upon exercise of economic and political power.
3. Contractual -- based upon some type of voluntary or cooperative contractual relationship.

McCammon contends that planned systems approach peak efficiency quicker than vertical systems that gradually evolve. This may well be true in that the coordinator of such systems has greater authority and power to stimulate efficiency. The long run effect of planned systems

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<sup>1</sup>McCammon, Bert C., Jr., "System Management", in Vertical Marketing Systems, op.cit.



on competitive intensity, responsiveness to consumers, innovativeness, equity and other performance dimensions is subject to greater debate. While data are lacking, one might suspect that while planned systems become tightly coordinated, efficient vertical systems more quickly than unplanned systems, they may also be more rigid systems (particularly corporate types of planned systems) which over time encounter problems of adaptability and responsiveness.

In planned systems based upon contractual relationships, some members of the systems may find themselves locked into a satellite relationship with the system "captain". Such positions of extreme dependency may be desirable for both entities as long as the marriage lasts. They may, however, impede warranted divorces, and most certainly pose serious hardships on the satellite firm if the relationship is abruptly ended.

These comments are largely speculative in nature due to the absence of analyses of planned vertical systems. It might well be fruitful to examine the behavioral dimensions of different types of vertical systems. For example, are planned systems characterized by higher levels of cooperation, as one would expect? Or, in planned systems where power is used to obtain cooperation, is there considerable conflict that is present but constrained? Is a certain amount of conflict necessary to stimulate progressiveness and adaptability?

In discussing social systems, Bertram Gross states:

"Conflict among and within systems is probably the greatest source of continuing change...The common interests and goals that keep a system together are always embedded in a network of divergent and competing interests and goals...Some degree of conflict -- both internal and external -- is an essential stimulus to system adaptability and creativity."<sup>1</sup>

System performance may be enhanced by moderate levels of both conflict and cooperation. Extreme levels of either, on the other hand, may be dysfunctional or unhealthy for the system. Thus, there may be a socially desirable balance of these two forces.

The interrelationship of cooperation-conflict and market structure, growth rate, new technology, market rules, and the nature of competition needs further examination to allow possible use of the cooperation-conflict idea. It seems entirely reasonable that the intensity of horizontal competition in a system may influence or be influenced by the balance of conflict and cooperation within the system. For example, a firm facing intense competition may place greater pressure on its suppliers, producing in turn greater conflict vertically. The dynamics of these relationships are not well understood but warrant additional examination.

Stern suggests measuring the performance of firms in a three-dimensional space of competition, conflict and cooperation, based upon the perceptions of other firms in the vertical system or at the same level

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<sup>1</sup>Gross, Bertram, "The State of the Nation: Social Systems Accounting" in Social Indicators, op. cit., p. 176, 177.

in the system.<sup>1</sup> Similarly, an index of conflict-cooperation might be developed for vertical systems based upon the perceptions of input suppliers who service several vertical systems and hence have some basis for comparison.

If, in fact, conflict and cooperation can be measured, then the factors influencing them become eligible for analysis. Regardless of the soundness of the hypotheses concerning conflict and cooperation, their usefulness by policy makers is likely to depend upon identification of the factors affecting the conflict-cooperation balance. I.e., what factors, over which the public sector has some control, influence conflict and cooperation? Further, what are the interrelationships between conflict, cooperation, competition and system coordination and adaptability? As the dynamics of vertical systems receive further attention, these are some of the critical questions needing an answer.

Yet another behavioral dimension -- power -- has an important bearing on the conduct and performance of vertical market systems. As Palamountain has suggested:

"It is apparent that a principal factor differentiating vertical conflict from horizontal or intertype competition is that it is so directly a power conflict."<sup>2</sup>

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<sup>1</sup>Stern, Louis W., "Antitrust Implications of A Sociological Interpretation of Competition, Conflict, and Cooperation in the Marketplace", The Antitrust Bulletin, Fall 1971.

<sup>2</sup>Palamountain, Joseph C. Jr., "Vertical Conflict", in Louis W. Stern, Distribution Channels..., op. cit., p. 135.

Economists have long been concerned about certain aspects of power, such as "monopoly power", "market power", and "bargaining power". However, these seldom embrace the total significance of power in vertical market systems. It is to this topic that we now direct our attention.

### The Dynamics of Power

Power is defined by Emerson in terms of the dependence of one actor upon another actor.

"The dependence of actor P upon actor O is (1) directly proportional to P's motivational investment in goals mediated by O, and (2) inversely proportional to the availability of those goals to P outside of the O - P relation."<sup>1</sup>

The power of O is thus dependent upon P's perception of O's ability to satisfy or inhibit P's desires and the number of alternatives perceived by P. This general definition can be applied to power in the marketplace, in the political arena, or in society in general.

It is important to recognize explicitly that one of the prime concerns of public policy is the acquisition and concentration of power in various forms, not only "market power". This concern is evident in the following comment by Attorney General John N. Mitchell in 1969:

"In 1948, the nation's 200 largest industrial corporations controlled 48 percent of the manufacturing assets. Today, these firms control 58 percent, while the top 500 firms control 75 percent of these assets.

The danger that this super-concentration poses to our economic, political and social structure cannot be over-estimated."<sup>2</sup>

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<sup>1</sup>Emerson, Richard, "Power-Dependence Relations", American Sociological Review, February 1962, p. 32-33.

<sup>2</sup>Mintz, Morton and Cohen, Jerry, America Inc., The Dial Press, N.Y. 1971, p. 16.

and in Senator Gaylord Nelson's statement, also in 1969:

"Americans, ever suspicious of concentrated political power, have permitted concentrations of economic power to develop, substantially unchallenged, that would make a Roman emperor gasp."<sup>1</sup>

From a public policy standpoint, the existence of power is of concern, whether or not it is used or misused. The very existence of power carries with it the potential for socially detrimental influence, and hence is a legitimate concern in a democratic society. As Mintz and Cohen suggest:

"It is the potential that is of foremost concern. The environment always to be sought is one which assures that ordinary men, not merely heroes, will reliably do what is necessary."<sup>2</sup>

Stern suggests that there are five bases of power in vertical market systems. These include rewards, coercion, expertness, legitimacy, and identification or referent power.<sup>3</sup> The first two, rewards and coercion power, are closely related and are similar to the gain and pain bargaining power suggested by some authors. These are the bases of power that are the most explosive, and most likely to generate conflict and reaction from other members of the system. In some cases, the exercise of reward or coercion power may stimulate efforts to countervail or neutralize such power. Galbraith suggests that it is natural for the weaker members of a power dyad

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<sup>1</sup>Ibid., p. 18.

<sup>2</sup>Ibid., p. 27.

<sup>3</sup>Stern, Louis, Distribution Channels, op. cit., p. 95.

to attempt to equalize the power relationship.<sup>1</sup> This may be achieved by forming coalitions, or by altering the dependency relationships.

Power is obviously a relative force. A firm may have considerable power in dealing with some suppliers, for example, but little power in dealing with others.

It is also well to distinguish between potential and realized power. For example, markets structure variables in certain combinations do represent potential sources of power in the market place. Whether in fact such power is realized depend upon whether it is offset or muted in some way.

Power is frequently viewed in a negative, exploitive sense. However, as Stern suggests:

"Power can be used to break down resistance to change, depending on the domain, weight, and scope of the power held by the agent seeking change, and to serve as a means for coordinating the efforts of all participants in the channel."<sup>2</sup>

In a similar vein, power may have a positive influence on system coordination by resolving conflict and stimulating greater commitment to and cooperation with a particular vertical system. Parson suggests that, in fact, power may be necessary for an industrial society to function.<sup>3</sup>

Assessing the magnitude and distribution of power in a vertical system is a difficult task that, to the author's knowledge, has not been

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<sup>1</sup>Galbraith, John K., American Capitalism, Houghton Mifflin Co., Boston, Massachusetts, 1956.

<sup>2</sup>Stern, Louis, Distribution Channels . . ., op. cit., p. 113.

<sup>3</sup>Parson, Talcott, "The Distribution of Power in American Society", in C. Wright Mills And The Power Elite, compiled by G. Wm. Domhoff and Hoyt B. Ballard, Beacon Press, Boston, Massachusetts, 1968.

attempted in a rigorous and systematic fashion. Because of the Robinson-Patman Act, prices will frequently not reflect the distribution of power in a system. The distribution of risk within a vertical system often provides some insights into the distribution of power. The patterns of credit and financing, and the various services rendered may also provide some clues.

Because power is largely a perceived force, the possibility exists to measure the magnitude and distribution of power as perceived by members of a system. While such an approach has been used to measure perceived power in some spheres, it has not as yet been attempted to study power in a vertical market system.

The Transience of Power -- Although relatively little is understood about the dynamics of power, a few comments are appropriate. Monopoly power has frequently been viewed by economists as quasi-permanent. Yet, it appears there are strong forces that continually erode existing positions of power. These include:

- 1 - The life cycle effect on product differentiation
- 2 - Increasing rate of technological change
- 3 - The difficulty of avoiding "organizational slack" in a firm with considerable market power
- 4 - Increasing willingness and ability of firms to enter unfamiliar industries; i.e., the number of potential entrants has increased
- 5 - The tendency for countervailing power to develop to offset or mute existing power
- 6 - Increasing competition from imports in many industries

The existence of a life cycle for many products means a gradual decline in product differentiation in the maturity stage, frequently accompanied by the increased importance of private labels. This phenomenon also stimulates the development and introduction of new products, which in turn

may shorten the life of older products. The impact of the life cycle on different industries varies greatly, however. Positions of monopoly power should be of greater concern in relatively stable, slowly changing industries, than in those where rapid changes and short life cycles prevail.

The increasing rate of technological change represents another threat to established positions of power. Changes in process, management, and/or product technology often provide opportunities for new entrants or smaller firms to successfully challenge and compete with established firms in an industry. This is particularly true where new technology makes obsolete large investments of existing firms. Existing firms may be understandably reluctant to "write off" former investments unless they are forced to by an aggressive innovator. Low entry barriers are obviously important for this to occur.

One of the frequent results of market power is a reduction of uncertainty and risk. Thus, a firm with considerable market power is likely to experience less anxiety and stress. The atmosphere of a relaxed firm, however, may allow a certain amount of organizational slack -- which in time may result in the erosion of its power base.

The growth of conglomerates, the expansion of technical competence in many firms, and the venturesomeness of the new breed of entrepreneurs has eliminated much of the hesitancy of firms to enter new and unfamiliar industries. This force alone has had a marked impact on the security and contentedness of many "old line" firms with established positions in certain industries.



The extent to which power tends to be neutralized, offset, or muted is unknown. It is apparent in certain situations, such as the growth of unions, the increase in farmer bargaining, the development of black power, student power and consumer power, and the development and growth of farmer cooperatives and retailer buying organizations. A firm's location within the marketing channel and the characteristics of the channel influence the extent to which power is offset. In those systems where the retail distributor is closely tied to the manufacturer as far as products handled (the petroleum and automobile systems, for example), the power of the retail distributor is likely to be less than where distributors handle the product lines of many manufacturers and are essentially independent in their operations. In food retailing, for example, where the products of many vertical systems are handled (including private labels), retail firms can be relatively independent in dealing with manufacturers. Thus, even though several food processing or manufacturing industries are differentiated oligopolies, their power tends to be muted by large retail organizations.

The foregoing forces cause a continual shift in the bases of power. They do not necessarily cause a reshuffling or redistribution of power, however. If, as Averitt suggests, many large firms have a guidance system that is "locked on" to product and technology changes that represent growth opportunities, they may be successful in continually refortifying this aspect of their power position. It would appear that large firms should be more adept at playing the game of musical chairs for shifting sources of

power than most smaller firms because of the former's longer run orientation and strong emphasis on growth.

The prevalence of countervailing power as a socially beneficial balancing force is subject to debate. Ralph Nader, in his introduction to America, Inc. states:

"During the past generation, a new theory of self-correcting mechanisms--countervailing powers or economic pluralism--gained acceptance. One power bloc, it is said, substantially curbs the excesses of another power bloc, whether they be big sellers, big buyers, big unions, big government, or the collective feedback of ultimate consumers.

...During the past six years, the realities of the corporate condition have begun to spill into the public domain...Counter-vailing power turns out to be mostly an accommodating power which transfers the results of corporate abuses from one point on the market or the environmental or governmental continuum until they land on the point of least resistance--the consumer-citizen-taxpayer."<sup>1</sup>

In commenting on the resilience and endurance of corporations, Nader strongly suggests that they are largely immune to the above transient dimensions of power.

"The management of power in a complex society is built around institutions. In our country, the most enduring, coordinated and generic manager of power is the corporate institution. Controlling great wealth and metabolized by the most fungible of factors--the dollar--the modern corporation possesses a formidable unity of motivation and action with great stamina.

Historically, many of our country's struggles have been challenges of the corporate power to define the area of its accountability. This was true of the Populist and Progressive movements as well as the challenges of organized labor and the regulatory state of the New Deal. Against these and lesser buffetings, the corporation, with its peerless resiliency of bending now and consolidating later, prevailed only to increase its power."<sup>2</sup>

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<sup>1</sup>Mintz & Cohen, America, Inc., op. cit., p. XV.

<sup>2</sup>Ibid., p. xi and xii.

Market rules have an important influence on the transience and distribution of power. Tax laws, anti-trust statutes, legislation on information that must be provided to consumers -- these and many other "market rules" influence the dynamics of power. An important vehicle by which large corporations maintain and increase their power is the corporate merger. The stance of federal regulatory agencies on mergers involving large companies can have a significant influence on the trends of power concentration over time, and on the extent to which power is actually transient.

Power In A Broader Sense -- The dangers or desirabilities of concentrated economic power depend upon an assessment of power and its influence in the greater society. Because of the obtuse nature of "power", solid empirical data is extremely difficult to obtain. Most analyses of power are thus a combination of the author's hypotheses with bits and pieces of supporting circumstantial evidence.

There are two basic concepts of power in the U.S., the elitists and pluralists. Since their difference suggest some of the key issues concerning power, they warrant comment.

Elitists -- C. Wright Mills was one of the leading proponents of the elitist point of view.<sup>1</sup> Mills' central proposition is that power has become increasingly concentrated in the U.S.; that a "power elite" made

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<sup>1</sup>For a compilation of several critiques and commentaries on Mills' work, see C. Wright Mills And The Power Elite, compiled by G. Wm. Domhoff & Hoyt B. Ballard, Beacon Press, Boston, Massachusetts, 1968.

up of a relatively small, tightly integrated group of people occupying the command posts of large organizations (corporate, political and military) control nearly all the important decisions; and that below the power elite are a middle power group -- made up of diversified interest groups, and the "mass society" -- a powerless mass of unorganized people controlled from above.

Pluralists -- As reflected in David Riesman's "The Lonely Crowd" (Doubleday Anchor, 1953), the pluralist point of view holds that no single unified power group exists in the U. S. Instead of a "power elite", the pluralists perceive a number of amorphous special interest or "veto" groups, each concerned with protecting their particular interests.<sup>1</sup> The presence of multiple centers of power provides one of the important restraints on power. In fact, Riesman warns that power may become so fragmented that effective leadership cannot emerge.

The implications of these two points of view are radically different. The elitist carry a strong concern for the exploitive and manipulative effect of concentrated power that, in their minds, is largely unconstrained. The pluralists, on the other hand, feel that power is effectively constrained for the most part, and therefore hold much less fear of its detrimental effects.

One of the critical issues in this debate is the relationship between large corporations, the very rich, and the body politic. Available data indicate that wealth is highly concentrated in the U.S. with no apparent

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<sup>1</sup>Ibid., p. 37 - 59.

trend toward deconcentration. There is also a strong ownership link between the very rich and large corporations. In 1953, the wealthiest 1 percent of the adult population held 76 percent of the corporate stock.<sup>1</sup> Whether, in fact, this means that the very rich effectively control most corporations in the U.S. is debateable. Parsons, Bell and others have argued that the control of business has passed into the hands of professional executives who have reached their positions through means other than the exercise of property rights. Bell contends that the death of family capitalism and the rise of managerial capitalism has meant that the keys to power have shifted from wealth to education, technical skill and political position.<sup>2</sup>

Domhoff challenges this contention. Drawing from his book, Who Rules America?<sup>3</sup>, he states:

"...This study showed that the less-than-one-percent who make up the American upper class contribute anywhere from 25 percent to 62 percent of the directors and partners of the largest banks, law firms, and corporations, and that these men and their hired employees dominate the philanthropic foundations, the boards of trustees of leading universities, the largest opinion-forming associations, the largest of the mass media, and the executive branch of the federal government. Two of the most important findings of Who Rules America? concerned the relationship between the old-line members of the upper class and the control of the corporate economy. On the one hand, it is clear that many members of the upper class continue to acquire the expertise necessary to function in the complex world of modern

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<sup>1</sup>"Estate-Tax Increases Get Little Support", The Christian Science Monitor, June, 1971. Also see Herman Miller, Rich Man, Poor Man, Signet Books, New York, 1964.

<sup>2</sup>Domhoff and Ballard, C. Wright Mills..., op. cit., p. 60-88, 251-278.

<sup>3</sup>Domhoff, G. Wm., Who Rules America?, Prentice-Hall, Englewood Cliffs, New Jersey, 1967.

corporations and law firms. On the other hand, it is clear that rising executives are assimilated into the social institutions of the upper class..."<sup>1</sup>

A related issue, particularly in recent years, is the extent to which large financial organizations -- which may be largely controlled by the upper class -- also influence or control other corporate entities. Discussing the situation in banking, America, Inc. states:

"...the Subcommittee on Domestic Finance of the House Committee on Banking and Currency...found that in 1967 institutional investors held \$1 trillion in assets. Of this sum, \$607 billion, or 60 percent, was held by the trust departments of the forty-nine commercial banks which the staff surveyed...Together,...the forty-nine banks in the survey held at least five percent of the common stock of each of 147 of the 500 largest industrial corporations. The same banks had a total of 768 interlocking directorships with 286 of the 500 largest corporations, or 'an average of almost three directors for each corporation board on which bank director representation is found'."<sup>2</sup>

Regarding concentration of power through newspapers, this same source notes that in 1910, 57 percent of the nation's cities and towns had daily newspapers under two or more separate ownerships. By 1970, this had dropped to 4 percent. In 1970, there were 1,483 cities with monopoly ownerships, compared to 64 with competing ownerships.<sup>3</sup> Further, a growing number of newspapers, radio stations and television stations are owned by conglomerate industrial and business corporations.

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<sup>1</sup>Domhoff, G. Wm., "The Power Elite and Its Critics", in C. Wright Mills..., op. cit., p. 269.

<sup>2</sup>Mintz and Cohen, America, Inc., op. cit., p. 19, 20.

<sup>3</sup>Ibid., p. 96.

The possibilities for conflicts of interest and incomplete reporting are thereby increased.

Even if we accept the implications of the above evidence indicating a broad swath of influence and power by individuals with wealth and/or corporate leadership, this still does not mean that these individuals are unified in some sense so that they operate as an elite group. Floyd Hunter's study indicated that many of the individuals identified as top leaders in the U.S. were personal acquaintances of several other top leaders.<sup>1</sup> That interaction occurs among these men is not particularly surprising. What is not known is whether this results in their acting with some degree of unity on major decisions. Pluralists contend that no such unity exists -- that in fact competition, not conspiracy, takes place between elites. Mills argued that the structural trends of society, similar socio-economic status, and similar psychological experiences in large institutions all formed the basis for unity. Without more evidence to go on, it is difficult to judge who is right.

Too little is known about the total impact, interrelationships and influence of economic power. The previous discussion has attempted to point out some of the key issues regarding power, and to draw attention to the caution flags being waved in certain quarters. Some will greet such comments concerning growing economic and political power as overexaggerations and unduly alarming. However, the potential detrimental effect

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<sup>1</sup>Hunter, Floyd, Top Leadership, USA, University of North Carolina Press, Chapel Hill, North Carolina, 1959.

on the U.S. economic, political and social systems is too great to justify dismissing these concerns lightly. On an issue such as this, the dangers from erring on the side of too great a concern appear far less than erring in the opposite direction.

Frequently, discussions of market structure focus solely on the implications for economic performance; yet, the power implications -- economic, political, and social -- are an underlying concern of many policy decisions. While a difficult and somewhat sensitive subject, more explicit consideration of power seems warranted in most studies of market, industry or system performance.

#### Concluding Comments: Vertical Systems Analysis

These comments have cast vertical market systems as evolving, interdependent social and economic systems that both influence and are influenced by the broader environment in which they are embedded. No adequate theory exists of vertical systems -- cast in this light.

In view of this, the foregoing discussion has attempted to summarize some of the concepts and hypotheses concerning vertical system behavior. The behavioral dimensions of conflict, cooperation and power were discussed at some length, due to their perceived strong influence on system coordination and adaptation. Some of the broader aspects of the power issue were also included because of the postulated interrelationships between economic, political and social power.



Relatively little empirical work has focused on the behavioral dimensions of vertical market systems. In view of this, while many intriguing hypotheses can be forwarded, few have been verified or refuted at this point. Hopefully, some of the more germane questions and issues have been identified in this discussion.

Although the present state of the arts of vertical systems analysis is rather bleak, the conceptual approach remains extremely attractive. Adopting the perspective of vertical systems as evolving, interdependent social and economic system stretches one beyond the structure of industries or the logistics-physical transformation focus of some analysts. It encourages consideration of both horizontal competitive relationships and vertical relationships; of the market rules and institutions that influence system behavior as well as the structure and conduct of corporate entities; of system adaptation and evolution as well as the efficiency and coordination of an existing system; and of behavioral forces as well as economic forces and relationships. Thus, the Weltanschauung it suggests is much broader and more realistic. Whether, in fact, it is so broad and complex as to defy rigorous and definitive analysis remains to be seen.